

**TESTIMONY BEFORE THE COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES**

**Hearing On:
*Tax Reform: Ensuring that Main Street Isn't Left Behind***

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Background

Thank you Mr. Chairman. I appreciate the opportunity to testify today on these important topics. My name is Dan McGregor and I am the Chairman of McGregor Metalworking Companies (MCGREGOR) and a board member of the S Corporation Association.

My family business began in 1965 as an investment with my father and 3 brothers. We purchased an 8 man tool and die shop in Springfield, Ohio. Since then, we gradually expanded to a total of four businesses in Springfield and another located in Aiken, South Carolina, employing a total of 375 workers spread across both states. These are good paying manufacturing jobs, with health insurance and retirement plans, in areas that need employment opportunities.

MCGREGOR is primarily engaged in contract manufacturing in the metalworking industry. We perform a wide variety of services such as metal stamping, spinning, welding, machining and assembly for customers in industries including locomotive, auto, agricultural, and lawn and garden companies. Our customers include General Electric, Honda, John Deere and many others.

We look at our taxes as another cost in a highly competitive, low-margin business. Almost all of our customers ask us for price decreases each year ranging from 1 to 3 percent. Contract manufacturing is under heavy competitive pressure from global and internal competition within our customer base.

Importance of the S Corporation to Family Businesses

From the beginning, MCGREGOR has been a family owned and run business. Our current shareholders are McGregor family members of the second and third generation. A central component of the success of our business has been our S corporation status.

When McGregor Metalworking was a C corporation, we paid out few dividends to our shareholders abiding by the minimum dividend payout rules. Growing the business was our objective and paying double taxation did not fit with our entrepreneurial spirit. This situation is often referred to as the "double tax" since the same business income is taxed

twice. The prevalence of the double tax leading to minimization of dividends to shareholders causes family C-Corporation shareholders not active in the business to become less interested in the success of the business. This is not a healthy situation for closely held businesses being passed on to the next generation.

In 1986, anticipating Congressional action to overhaul the tax code, we converted to S corporation status. At the time, we thought that the opportunity to be taxed as a “pass-through” to eliminate the double corporate tax would allow us to reinvigorate our company and our shareholders. Sure enough, after nearly 30 years as an S corporation, I am positive there is no better way to organize a family business like my own.

So much has been written about the erosion of the corporate tax base in recent years that an essential reality has been lost – the business tax base is larger today than it was prior to 1986 tax reforms. It is true the corporate base has declined since 1986, but the growth of the pass through business sector has made up for it and more.

According to the Tax Foundation, when my company converted to an S corporation in 1986, pass-through businesses contributed only 1 percent to our GDP. Today, pass-through businesses make up 6 percent of U.S. income. As a result, the business tax base – combining corporate and pass through businesses -- has expanded from 9 percent to 11 percent of our national income. The United States today is more entrepreneurial because of the 1986 tax reforms and the growth of the pass through business sector.

S Corporation Taxation & the Fiscal Cliff

There is much confusion about how S corporations are taxed. We pay tax on all our business income when it is earned and regardless of how much is distributed to our shareholders.

Since the tax is paid at the shareholder level, we make sure to distribute every quarter enough earnings for shareholders to pay their tax estimate. And since S corporations are allowed only one class of stock, those distributions must be equal to the highest marginal rate faced by any of my shareholders.

Prior to the fiscal cliff resolution, the top federal marginal rate was 35 percent and the business as a whole had a tax rate of about 33.3 percent taking into account federal deductions for section 199 and the R&E tax credit as well as state and local taxes. That meant that every quarter we would distribute at least 34 cents of every dollar we earned to pay the S corporation’s taxes.

Following the resolution of the fiscal cliff, the top tax rate on my shareholders increased to approximately 41.4 percent due to the higher 39.6 percent marginal rate plus, where applicable, the new 3.8 percent Affordable Care Act tax and the effect of the reinstatement of the Pease limitation on itemized deductions. As a result, today we have to distribute approximately 42 cents of every dollar earned so our shareholders can pay the federal, state and local S corporation tax.

This sharp increase has hurt our ability to compete, grow, and create jobs. Think about it this way -- we are in a capital intensive business and have two sources of capital: what we can borrow from the bank and what we retain from our earnings. Unlike a large multinational, we simply do not have access to the public capital markets.

During the “big recession” of 2008 and 2009 our bank added two covenants to our loans: First, a **debt service coverage ratio** where free cash flow must cover bank payments by a multiple of 1.25 and, second, a cap on our **total debt to equity** not to exceed a multiple of two. In order for our companies survive and grow, we need retained earnings, but right now they are being depleted by our tax burden.

Prior to the fiscal cliff, we were able to retain up to 66 cents of every dollar we earned. Those retained earnings formed the core of our working and investment capital and over the years we used them to grow the business from 8 workers to 375. After the fiscal cliff, we have the option to retain only 58 cents of a dollar of earnings, depending on our annual budget and capital needs.

I use a rough estimate that it takes between \$30,000 and \$40,000 of after-tax earnings coupled with prudent bank debt to create the investment that will justify a new hire. Having MCGREGOR’s effective tax rate rise from 34 to 42 percent means lots of lost job opportunities.

Tax Reform

I understand Congress is struggling with the challenge of reforming the tax code and making our approach to taxing business income more competitive. Part of this discussion is the need to reduce the tax rate imposed on C corporations. It’s hard to compete against foreign companies when you are paying significantly higher levels of tax. I am sympathetic to these concerns and I know that the S Corporation Association has been supportive of cutting the corporate rate to something more in line with the rest of the world.

But the same arguments that support cutting the corporate rate also apply to pass through businesses like my own. We face the same competitive pressures as C corporations, and we currently pay a higher tax rate than both the company headquartered overseas *and* the C corporation down the street.

Tax reform that broadened the tax base while reducing the tax rate on C corporations only would increase this disparity. Under the worst case scenario where MCGREGOR loses LIFO, the R&E tax credit, and the Section 199 deduction, I estimate our effective tax rate would rise from 42 to in excess of 46 percent. No amount of expensing or other band aide provisions could offset this hit.

A 2011 study by Ernst & Young reinforced this point. They found that corporate-only reform would raise taxes on my company and others like it by 8 percent per year or \$27billion overall -- and that does not include the effects of the 2013 fiscal cliff tax hike.

This recent history illustrates why the proposals for “corporate-only” tax reform are so troubling to me and other owners of pass-through businesses. Rather than provide needed

rate relief to all businesses, corporate reform would reduce rates on C corporations only, increasing the differential between C and S corporation top rates from the current five to ten percentage points up to fifteen percentage points and more. It would return the tax code to pre-1986, when nearly all businesses were C corporations and tax considerations played a measurably negative role in their governance.

It also would leave S corporation owners with two equally painful choices. We could remain an S corporation and attempt to compete against domestic and foreign companies while paying significantly higher tax rates. Or we could convert back to C status to access the lower rate and, like most C corporations, stop paying dividends to avoid the double tax.

This inability to share our company's earnings among family members would strike at the very heart of our identity as a family-owned business. Why own a private business if you are unable to share in its success? Under such circumstances, selling the business to a public corporation with no need to pay dividends and a ready market for its stock would become increasingly attractive. It would also mean that the business decisions affecting 375 workers in Springfield would now be made in a corporate boardroom someplace else.

As an alternative to corporate-only tax reform, the S Corporation Association and other allied trade groups have advocated for three key principles to be adopted in any tax reform effort:

1. Tax reform should be simplified, comprehensive and improve the tax treatment of individuals, pass through businesses and corporations alike;
2. Tax reform should seek to restore rate parity for the top rates paid by individuals, pass through businesses and corporations; and
3. Tax reform should seek to reduce or eliminate the double tax paid by C corporations.

These principles are articulated in a letter attached to the back of my testimony and supported by over 100 business groups, including the National Federation of Independent Business, the Precision Metalforming Association, the American Farm Bureau, and the National Restaurant Association.

Other Tax Considerations

Let me briefly mention three other tax issues of importance to MCGREGOR.

First, as a manufacturer, MCGREGOR engages in a significant level of research and development, and we therefore take advantage of the R&E tax credit. The usefulness of the credit is limited, however, by the Alternative Minimum Tax (AMT). When the advantages and disadvantages of the pass through business structure are discussed, the role of the AMT rarely comes up, but it is significantly negative. Not only does the AMT raise the taxes of many of my shareholders, it also precludes them from benefiting from the R&E tax credit, thereby diluting the value of the credit to MCGREGOR. Allowing taxpayers paying the AMT to access the R&E tax credit would solve this problem. Getting rid of the AMT entirely would be even better.

Second, as a family owned business, succession and the estate tax are a constant challenge for MCGREGOR. The outcome of the fiscal cliff negotiations set the estate tax exemption to \$5 million and the marginal rate at 40 percent, but for a business the size of MCGREGOR, those levels mean we still have to deal with the effects of the estate tax as our shareholders grow older. Any family that grows their business beyond that exemption level must constantly make this tax part of their family business strategy. Often tax strategy is contrary to the best interests of the business and the family members. Transition of ownership in privately held businesses is never easy and the estate tax is often the death knell of family business continuance.

Finally, there are a number of smaller tax items improving the governance of S corporations that should be enacted and/or made permanent, including the shorter recognition period for built-in gains and leveling the tax treatment of charitable donations of S corporation stock. These provisions have been championed by Representatives Reichert (R-WA) and Kind (D-WI) for years and have already passed the House this year.

Conclusion

McGregor Metalworking has been proud to provide quality, high paying jobs to workers in Springfield for over 50 years. S corporations around the country do the same thing, employing one out of four private sector workers and contributing significantly to our national income. The reforms enacted in 1986 helped MCGREGOR and other S corporations thrive by allowing us to operate in a significantly superior business structure. Any reform considered by Congress should seek to strengthen and grow the pass through sector. With the tax reform principles I have laid out today, I am confident that MCGREGOR and other pass-through businesses will continue to drive job creation and economic growth in communities like Springfield for years to come.

Thank you for your time and I am happy to answer any of your questions or even better I invite you to come to Springfield to visit our plants and see the results of reinvestment by S Corporations.